

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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OFFICE OF THE SECRETARY

In the Matter of)
)
1998 Biennial Regulatory Review --) CC Docket No. 98-137
Review of Depreciation Requirements)
for Incumbent Local Exchange Carriers)
Summary)

COMMENTS OF SPRINT CORPORATION

SPRINT CORPORATION

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SUMMARY

In these comments, Sprint Corporation (“Sprint”) offers its opinion that the depreciation prescription for price cap LECs should be discontinued in total. In the event the Commission declines to adopt Sprint’s recommendation on this point, Sprint urges the Commission to adopt its proposal to reduce the depreciation filing to four summary exhibits. However, Sprint recommends that only two factors need to be included on the schedules.

With respect to the Commission’s proposal regarding the projection life ranges for digital switching equipment, Sprint notes its belief that it is unnecessary to establish equipment life ranges for price cap LECs. Once again, however, to the extent the Commission proceeds to prescribe such ranges, Sprint expresses its concern about the Commission’s proposal to use projection lives rather than remaining lives in the ranges. Sprint proposes that the Commission convert projection life ranges to remaining life ranges and cease the evaluation of projection lives independent of to the remaining life components. ILECs that file a remaining life outside of the range for an account may then submit more detailed studies to justify their selected remaining life. Finally, Sprint recommends that the specific ranges proposed by the Commission should be rejected. In their place, the Commission should adopt the remaining life ranges contained in the study conducted by Technology Futures, Inc.

Sprint strenuously opposes the Commission’s proposal to eliminate the future net salvage factor for the depreciation formula. Sprint asserts that, regardless of the subjectivity and complexities involved, deprecation accounting, inclusive of net salvage,

is an essential element in the prudent financial management of a company and thus should be retained.

Sprint concurs in the Commission's conclusion that the same definition of mid-sized LECs used in its ARMIS proceeding should be applied to depreciation prescription requirements and that these companies should be subject to a lighter regulatory reporting burden than that imposed on larger LECs.

Sprint asserts that ILECs should be permitted to set their own depreciation rates while still remaining eligible for the low-end adjustment. The rate chosen, however must be tied to the rates used for external reporting in audited financial statements. Sprint explains that, to the extent the Commission wishes to have a mechanism by which it can ensure that the depreciation included in the rate of return calculation is at the proper level, it can rely on the external audits conducted of all LECs. Moreover, the Commission should require a company that claims a low end adjustment to make an explicit and sufficient showing in its filing that its chosen depreciation rates are reasonable. Additionally, the Commission should affirm that changes in depreciation expenses resulting from this proceeding are not to be afforded exogenous cost treatment.

Finally Sprint maintains that the depreciation rates, as represented on the books of a carrier, should not be used for cost modeling purposes. Specifically, if the Commission is requiring a forward-looking cost methodology to be used to calculate the costs associated with unbundled network elements or universal service, then it should use that same forward-looking cost methodology to calculate depreciation as well.

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COMMENTS OF SPRINT CORPORATION

Pursuant to Section 11 of the Communications Act of 1934, as amended, the Commission has conducted a review of its regulations concerning the depreciation prescription process. On October 14, 1998, the Commission issued a Notice of Proposed Rulemaking ("NPRM") in this matter inviting comment on suggested changes resulting from that review.

Specifically, the Commission proposes to reduce or streamline further the depreciation prescription process by permitting summary filings and eliminating the prescription of depreciation rates for incumbent local exchange carriers ("ILECs"), provided that the carrier uses depreciation factors falling within Commission approved ranges. The Commission does, however, seek comment on whether carriers should be permitted to set their own depreciation rates if they are willing to waive the automatic low-end adjustment. Finally, the Commission further proposes to expand the prescribed range for the digital

switching plant account and to eliminate entirely the future net salvage factor from the depreciation process.

Sprint offers the following comments in response to the proposals set forth in the NPRM.

I. Filing and Prescription Procedures

At paragraph 10 of the NPRM, the Commission proposes that depreciation factors continue to be filed with the Commission, although the filing would be reduced to four summary exhibits if the carrier selects depreciation factors from within the Commission's specified ranges. It is Sprint's belief that the depreciation prescription for price cap LECs should be discontinued in total. If Sprint's position were adopted, there would be no need to file schedules detailing the depreciation factors. However, if the Commission finds that the LECs must continue to make the filings, Sprint supports reducing the filing to include only four summary exhibits. Having said that, however, Sprint also believes that only two factors need to be included on the schedules.

Currently, the depreciation factors consist of two parameters: future net salvage ("FNS") and average remaining life ("ARL"). These factors, in conjunction with the carrier's accumulated depreciation balance as a percentage of surviving investment, populates the depreciation rate formula as follows:

$$\text{Depreciation Rate} = \frac{100\% - \text{accumulated depreciation \%} - \text{future net salvage \%}}{\text{Average remaining life}}$$

In this NPRM, the Commission has proposed what it suggests are acceptable ranges of projection lives to be used by ILECs. Sprint submits that information representing (1) the accumulated depreciation as percent of investment, (2) future net salvage as percent of investment, and (3) average remaining life, are the sole factors that ILECs should provide in streamlined filings with the Commission. The projection life parameter is an arcane vestige of depreciation mortality analysis that is poorly understood and difficult to apply properly in the situations (described in paragraph 6 of the NPRM) in which depreciation factors continue to be used.¹ If necessary, the Commission could conduct a basic assessment of the reasonableness of the remaining life of plant and thus significantly streamline the review and prescription process.

II. Equipment Life Ranges

At paragraph 11 of the NPRM, the Commission proposes changing the projection life ranges for digital switching from a range of 16 to 18 years to what it describes as a wider range of 13 to 18 years. Sprint does not believe that establishment of equipment life ranges is necessary for carriers subject to price cap regulation. While the Commission may believe that prescribed ranges are needed to protect against manipulation by the carriers, Sprint asserts that, to the

¹ Calculation of a low-end adjustment, recalculation of the productivity factor, exogenous cost determination, calculation of the Base Factor Portion that is used to determine how much a carrier can recover through End User Common Line charges, cost support a carrier would have to provide if it proposed an API higher than its PCI, forward-looking economic costs for universal service high cost loop support purposes, rates for interconnection, pricing unbundled network elements, and takings claim under 5th amendment.

contrary, existing safeguards (such as external audits, discussed below) will prevent such abuses from occurring.

In the event that the Commission does adopt equipment life ranges, Sprint is concerned with the proposed use of projection lives rather than remaining lives in the ranges. To establish the remaining life for digital switching that results from this proposed change, the ILEC would be required to:

- Create a complete age distribution of surviving plant investment as a proportion of total plant placed. This age distribution incorporates historic transfers, adjustments, and accounting reclassifications. Where a complete actuarial record is not available, various statistical methods must be employed to establish the age distribution.
- Select a survivor curve. The single survivor curve selected must indicate the retirement pattern for all vintage years of plant placed. These curves come in several families of standard curves including the Gompertz-Makeham curve, the Iowa curve, and New York h-curve. Each curve within these families of curves plots a proportion of investment surviving as a percent of average life. Some curves project significant retirements in early life with a small proportion of plant surviving for a very long time, while other curves project few retirements to occur before the average life is reached. Curve selection is influenced by historic experience, but must also reflect assessment of future causes of equipment mortality. As discussed at footnote 22 of the NPRM, the survivor curve determines the ARL. However, the Commission has not established ranges of curve shapes acceptable for use with the range of projection lives.
- Apply the appropriate service life weighting technique. Various jurisdictions have different rules regarding the application of Vintage Group and Equal Life Group service life weighting. Typically, there is a mix of Vintage Group and Equal Life Group service life weighting within the analysis of a single account.

These other components – the age distribution, survivor curve, and service life weighting technique -- are used in conjunction with the projection life

to establish the remaining life parameter found in the depreciation rate formula. These other components have been the basis of considerable litigation in many jurisdictions, because the application of each is predicated on numerous and abstract statistical assumptions. This style of depreciation regulation is obsolete in today's environment.

To streamline the depreciation filing and prescription procedure, Sprint proposes that the Commission convert projection life ranges to remaining life ranges, and cease the evaluation of projection lives independent of the other remaining life components. ILECs that file a remaining life outside the range for an account may submit more detailed studies that justify their selected remaining life.

As further justification for reliance on remaining lives, Sprint notes that remaining life ranges will allow the Commission to include "dying accounts" in the range of acceptable values. As a result of earlier Commission orders,² it was determined that accounts containing information on analog electronic switching, electro-mechanical switching and aerial wire, should be excluded from the specification of ranges due to the rapid phasing out of obsolete equipment. Sprint asserts that other accounts may be added to the list of dying accounts due to future technological advancements. For example, ATM switching may cause circuit switching accounts to become dying accounts in the future. The

² *In the Matter of Simplification of the Depreciation Prescription Process*, Third Report and Order 10 FCC Rcd 8442 (1995).

remaining life is by far the most effective and unambiguous life parameter for evaluating such accounts.

Sprint further avers that the proposed change in the lower limit of the life range for digital switching, while a step in the right direction, is insufficient. Sprint also contends that other currently prescribed ranges should be expanded as well. The Commission's rationale for expanding the range for digital switching is based on its belief that the retirement rates for digital switching will continue to increase. In other words, in order to establish proper depreciation initially, rather than inadequately low depreciation followed by inappropriately high depreciation, ranges need to be expanded.

Technology Futures, Inc. has conducted a thorough study of life characteristics of telecommunications plant.³ That study includes ranges that provide greater flexibility to allow for the specific facts and circumstances of individual companies to be reflected in depreciation rates. If adopted, these ranges would still provide an outside check on the depreciation rates used, but would avoid the cost burden of a depreciation filing and approval for ranges outside the Commission's established ranges. Sprint, therefore, proposes that the established remaining life ranges outlined in the Technology Futures, Inc. study be adopted rather than the ranges proposed in the NPRM.

³ *Transforming the Local Exchange Network: Analyses and Forecasts of Technology Change*, by Lawrence K. Vanston, Ray L. Hodges and Adrian J. Poitras. © 1997, Technology Futures, Inc.

III. Proposed Treatment for Salvage and Cost of Removal

Sprint strenuously opposes the Commission's proposal to eliminate the future net salvage factor from the depreciation formula and instead record salvage and cost of removal as a current expense in the period incurred. Sprint agrees that the estimation of net salvage is not a scientific process; similar complexities are inherent in establishing service life estimates for depreciation purposes. However, regardless of the subjectivity and complexities involved, depreciation accounting, inclusive of net salvage, is an essential element in the prudent financial management of a company.

As the telecommunications industry continues to become more competitive, all efforts should be made to more closely align regulatory reporting requirements with accounting principles utilized by non-regulated business, namely the generally accepted accounting principles ("GAAP"). The Commission's proposal appear to move in the opposite direction and thus its adoption place ILECs at a disadvantage with respect to their competitors.

The American Institute of Certified Public Accountants' ("AICPA") defines depreciation accounting as:

...a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated

useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. supports salvage as a component of the depreciation process.⁴

Clearly, this definition anticipates salvage as a component of the depreciation process.

Moreover, incorporated within this definition are also the GAAP concepts of matching and accrual accounting. Specifically, AIPCA maintains that:

[T]o be rational, depreciation generally should match the consumption of the assets. Matching expense recognition with consumption ensures that financial statements accurately reflect the results of operations. Under the accrual concept of accounting, capital expenditures are recovered through depreciation after they are made, the credit for salvage is recognized before receipt, and the charge for cost of removal is accrued before expenditure. Thus, all the costs of ownership are reflected over the productive life of owned assets.⁵

Further, the Commission's proposal regarding the treatment of the salvage factor appears to be in conflict with the Financial Accounting Standards Board ("FASB") Exposure Draft No. 158-B, *Accounting for Certain Liabilities Related to Closure or Removal of Long-Lived Assets*. The stated objectives of the Exposure Draft are "to establish accounting standards for the recognition and measurement of closure or removal obligations that both (a) reflect the current obligation of an entity for closure or removal of its long-lived assets and (b) allocate the costs of closure or removal over the useful life of the long-lived assets." In October 1997, the Board elected to continue with the project and

⁴ § 6.03 [1] Accounting for Public Utilities.

⁵ *Id.*

proceed toward the issuance of another Exposure Draft (expected in the first quarter of 1999). Sprint, therefore, contends that the adoption of the Commission's proposed change in the treatment of salvage and cost of removal would be poor policy. Making the decision now, before the FASB has released its Statement of Financial Accounting Standards would be even worse.

Elimination of the future net salvage factor from the depreciation formula would place ILECs at financial risk as well as placing them in a competitive disadvantage with new entrants to the market. Due to the capital intensity of the industry coupled with the clustering of retirements of long-lived assets associated with technological obsolescence, and high cost of removal, it is not unusual for the future net salvage factor to accrue a significantly higher level of expense than the actual period expense incurred. This difference compounded over time would generate a material liability for the carrier and a cost burden for future ratepayers to fund. Further, the competitive environment of the industry places the ILEC's ability to recover this deferred liability from future ratepayers at significant risk.

In addition, the proposed elimination of the prevalent accounting practice to accrue for the net salvage ratably over the useful life of the asset could lead to volatility in financial statements. If period salvage value is a material positive amount in a single accounting period, the profits might be somewhat higher than in previous years. When excessive removal costs occur in one accounting year, the reverse effect on the profit and loss statement would prevail. Due to the

dynamics of the industry and associated technological advances it is contemplated that mass retirements will be experienced in the future supporting the later of the two scenarios. This volatility could negatively impact the financial viability of the ILEC, lower bond ratings, etc., making it more costly for the carrier to operate.

Additional administrative costs, while less significant, are none the less an equally important issue to consider prior to finalizing a position to eliminate the future net salvage factor from the depreciation formula. For external GAAP financial reporting purposes, an ILEC would continue the practice of accruing net salvage ratably over the useful life of the asset. It is highly probable that the state public utility commissions would require its continued application as well. As a result, the ILEC would incur additional administrative expense to maintain a separate process for Commission purposes. The additional administrative burdens of maintaining multiple regulatory books outweigh the anticipated savings to be realized from the elimination of the future net salvage factor.

In response to the Commission's directive in paragraph 15 of the NPRM, Sprint estimates that the elimination of the accrual for future net salvage would reduce depreciation expense by approximately 12%. The recording of salvage and cost of removal as a period expense would slightly offset this reduction by an estimate of 2%. The net result is equivalent to a depreciation expense reduction of approximately 10%. This situation is true for the current period;

however, the situation could reverse in the future as retirements significantly increase.

If future net salvage were to be eliminated, it would be necessary to prescribe new depreciation rates. Sprint proposes that the accumulated reserve for net salvage be disaggregated from the depreciation reserve, grandfathered and held in advance to normalize significant future year over year fluctuations in current period net salvage expenditures.

A secondary proposal for the handling of the accumulated reserve for net salvage would be to conduct a depreciation rate study wherein the component for future net salvage would be eliminated. The study would result in the amortization of the accumulated reserve for net salvage over the average remaining life of the plant in service. This process would generate an additional reduction in depreciation expense of approximately 6%. Overall expense reductions under this proposal, including the net impact of eliminating future net salvage (12%), partially offset by an increase in current period expense (2%) would be the equivalent of a net reduction in depreciation expense of approximately 16%.

The implicit future net salvage liability for the Company is equivalent to 13% of investment or 200% of annual depreciation expense. Considering the significant materiality of the Commission's proposed handling of net salvage as a period expense, Sprint strongly urges the Commission to abandon its proposal,

and opt instead for continuation of the prevalent accounting practice to accrue net salvage ratably over the useful life of the asset.

Finally, at paragraph 16, the Commission proposes to create a new account to record both salvage receipts and removal costs. While Sprint again urges the Commission not to move forward with its proposal to remove net salvage from the depreciation process, Sprint agrees that to the extent the Commission adopts the proposal, a new account (Account 6566) should be created to record net cost of removal. Sprint also agrees that it would be necessary to revise Sections 32.3100 and 32.2000 to eliminate the provision that salvage and cost of removal be recorded in the depreciation reserve account. Sprint believes, however, that subsidiary record requirements relating to Account 6566 should be left to company discretion.

IV. Reporting Requirements for Mid-Sized LECs:

Sprint concurs with the Commission's conclusion that the same definition of mid-sized LECs used in the ARMIS proceeding⁶ should be applied to depreciation prescription requirements and that these companies should be subject to a lighter regulatory reporting burden than that imposed on larger LECs. Sprint applauds the Commission's recognition that mid-sized LECs, such as the Sprint LECs, require relief from the administrative burdens that

⁶ *In the Matter of the 1998 Biennial Review of ARMIS Reporting Requirements*, CC Docket 98-117, Notice of Proposed Rulemaking released July 17, 1998.

accompany many of the regulatory reporting requirements, including the annual theoretical reserve study. The Commission is correct in its expressed belief that the level of detail required of a mid-sized LEC is both burdensome and costly to provide. It should, therefore, adopt its proposal as outlined at paragraph 17 of the NPRM.

V. Low-End Adjustment

At paragraph 18, the Commission seeks comment on whether or not ILECs should be permitted to set their own depreciation rates. Sprint asserts that ILECs should be permitted to set their own depreciation rates while still remaining eligible for the low-end adjustment. The rate chosen, however, must be tied to the rates used for external reporting in audited financial statements.

In posing its question, the Commission's expresses some fear that, without its oversight, "...carriers could manipulate depreciation expense to reduce their return and obtain a price increase through the low-end adjustment" (NPRM at ¶18). The flaw in this reasoning is that it inaccurately assumes that a carrier could set whatever depreciation rates it wishes. The fact is that, regardless of what the Commission does here, the depreciation rate used in a company's audited financial statement must withstand an audit by an outside certified public accounting firm in order for the company to get a clean opinion. Consequently, providing the ILECs with this measure of flexibility will not open the door to unfettered abuses by the carriers.

With respect to the question of the low-end adjustment, a company should not be forced to use inadequate depreciation rates as an insurance policy, simply to protect itself from uncontrollable economic factors or unanticipated regulatory actions.

On the other hand, Sprint understands that the Commission must have some mechanism to ensure that the depreciation included in the rate of return calculation is at the proper level. Reliance on external auditors, as described above, should provide that assurance. Sprint also believes that the other contexts identified by the Commission, i.e., a recalculation of the productivity factor, an exogenous cost determination, a calculation of the Base Factor Portion that is used to determine how much a carrier can recover through End User Common Line charges, the cost support a carrier would have to provide if it proposed an Actual Price Index ("API") higher than its Price Cap Index ("PCI") would also be satisfied by reliance on external auditors or, as described below, a special showing by the company.

In the event that the Commission believes that further control is necessary, Sprint recommends that a company be allowed to make a showing on its depreciation rates. Rather than simply denying the low end adjustment outright because a carrier did not employ Commission-approved ranges, the Commission should rather require a company to make an explicit and sufficient showing that its chosen depreciation rates are reasonable.

Changes in depreciation expenses are not currently considered exogenous costs under the Commission's price cap rules. The Commission should continue this policy and not allow exogenous treatment for any depreciation changes resulting from this proceeding.

VI. Other Comments

At paragraph 4, the Commission states that:


In addition to these price cap effects, changes in depreciation expense may also affect prices or federal support payments through new mechanisms created to implement the Telecommunications Act of 1996. For example, the Commission required incumbent LECs to use depreciation factors within the FCC authorized ranges when calculating forward-looking economic costs for universal service high cost loop support purposes. Also, state commissions have required incumbent LECs to use interstate depreciation rates or life and salvage factors developed during the Commission's depreciation prescription process when calculating rates for interconnection⁷ or unbundled network elements. Finally, depreciation may play a role in a takings claim under the Fifth Amendment.

Sprint maintains that the depreciation to be recorded on the books of the ILEC is designed to reflect the loss in service value of those capital assets also on the books and currently used and useful in providing service. Consequently, the depreciation lives, salvage, and cost of removal of embedded plant would match the lives, salvage, and cost of removal of forward-looking plant investments only

⁷ See Application of Bell Atlantic-Delaware, Inc. for Approval of its Statement of Terms and Conditions Under Section 252(f) of the Telecommunications Act of 1996, Findings and Recommendations of the Hearing Examiners, PSC Docket No. 96-324 at p. 40 (Apr. 7, 1997) ("The FCC prescribed lives are forward-looking and appropriate to use in a TELRIC model."), adopted in Interlocutory Order No. 4488 (Apr. 29, 1997); Public Utility Commission of Texas, FTA96 § 252 Arbitration Panel, PUC Docket Nos. 16189, 16196, 16226, 16285 and 16290, Arbitration Award at p. 33 (November 7, 1996) (requires Southwestern to use the average service lives and salvage factors prescribed by the FCC); Order Approving Interconnection Agreement (Dec. 19, 1996); Texas State Statutes, Article 1446(c)(o).

by coincidence. The perceived need for depreciation oversight in the prescription process that relates to forward-looking cost models for universal service fund or unbundled network element costs would, therefore, be avoided if depreciation costs were treated as other costs in the models -- in other words, if the costs are not tied to embedded investment, but are, instead, forward-looking.

Respectfully submitted,
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November 23, 1998

CERTIFICATE OF SERVICE

I, Melinda L. Mills, hereby certify that I have on this 23rd day of November 1998, served via U.S. First Class Mail, postage prepaid, or Hand Delivery, a copy of the foregoing "Comments of Sprint Corporation" In the Matter of 1998 Biennial Regulatory Review -- Review of Depreciatoin Requirements for Incumbent Local Exchange Carriers, CC Docket No. 98-137, filed this date with the Secretary, Federal Communications Commission, to the persons on the attached service list.



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